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DEPT PASS TO USTR MDELANEY/CLILIENFELD/AADLER
TREASURY FOR OFFICE OF SOUTH ASIA MNUGENT
TREASURY PASS TO FRB SAN FRANCISCO/TERESA CURRAN

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SUBJECT: INDIA UNLIKELY TO MEET $500 BILLION INFRASTRUCTURE SPENDING TARGET

¶1. (SBU) Summary. Both Government of India (GOI) officials and private sector experts expect the GOI to fall far short of its plan to spend $500 billion on infrastructure between 2007 and 2012. Public-private partnerships have become an acceptable format for such projects but the private sector remains a small player due to a lack of bankable projects, uncompetitive expected returns, and several local and sector-specific problems. The private sector shortfall is primarily due to inadequacies in the policy environment, with the GOI lacking the energy or capacity to create projects that meet the private sector's desire and financial ability to invest. This approach will have to change if India wants to meet its economic growth targets over the long-term. End Summary.

¶2. (SBU) The GOI Planning Commission set out an ambitious infrastructure spending plan in its Eleventh Five-Year Plan (2007-2012), calling for $500 billion to be spent on infrastructure during the next five years. Progress, however, has been slow. Ministry of Finance Joint Secretary for Investment and Infrastructure Govind Mohan told Econoff that in the first two years of the plan, India spent only about $75 billion total. Mohan said the crucial years to meet the plan would be 2011 and 2012, when the GOI is expecting a substantial jump in infrastructure spending. However, Mohan later said that he is expecting India to fall far short of its $500 billion in infrastructure spending target after five years.

¶3. (SBU) Despite the results to date, Mohan still was quite positive about the GOI performance for increasing the amount spent compared to past spending and changing the GOI mindset regarding infrastructure financing. Even if the GOI does not meet its target, Mohan said, it will still have spent much more on infrastructure than in the 10th Five-Year Plan. More importantly, said Mohan, the GOI has taken an ideological leap in breaking from the past to embrace public-private partnerships (PPPs). Prior to 2007, there were no PPPs for infrastructure development but the GOI is now expecting to finance 30 percent of its infrastructure investment through PPPs. Mohan said PPPs have now taken deep roots within the GOI and India has leapfrogged other countries in supporting PPPs.

¶4. (SBU) Private sector contacts, however, were not as quick to put a positive spin on the GOI's efforts to increase infrastructure spending. Vinayak Chatterjee, Chairman of Feedback Ventures, an Indian infrastructure services company, told Econoff the GOI would spend $275 to $300 billion in the Eleventh Five-Year Plan, only slightly more than the $222 billion spent from 2002-2007. He said it was government hype that 30 percent would be from PPPs. Rather, he expected it to be closer to 20 percent, a figure several other

potential investors mentioned as well.

¶5. (SBU) For the private sector, the issue is not a problem of finding financing despite the economic times, but rather the GOI itself. According to Chatterjee, the GOI - center, state or local level - does not have the energy or capacity to create bankable projects. Even Saumitra Chaudhuri, a member of the Planning Commission, told Econoff that the problem is the "malaise of government." Brooks Entwistle, CEO of Goldman Sachs India, told Econoff that the result of government performance is that there are not a lot of "clean, unencumbered" projects that can compete on returns with other developing countries - or even developed countries. Entwistle noted that Goldman Sachs can get the same return on a road project in Pennsylvania as it could in India, where the uncertainty and risks are higher.

¶6. (SBU) India is flush with foreign capital, as foreign direct and indirect investment is increasing rapidly each month. Lots of cash but few bankable projects have led to a seller's market, according to Chatterjee. Doing a "back of the envelope" calculation, Chatterjee thought there was only about $60 billion worth of projects for the private sector to invest in over a five year period or just $12 billion per year. (Note: Chatterjee assumed that in five years $300 billion would be spent on infrastructure, 20 percent of which would be financed by PPPs. End note.) Chatterjee thought part of the problem keeping returns low was there was too much cash chasing too few projects.

¶7. (SBU) Local factors are also keeping returns low or making it difficult for international investors to invest in infrastructure projects according to Sreekumar Chatra, Associate Director of

Macquarie Capital Advisors. Chatra told Econoffs that required returns on domestic capital are lower than required returns on international capital as there is a difference of opinion on risk, equal to five to six percent. Indian investors are also willing to accept lower returns since, in many instances, they also act as the project contractors, generating fee income that compensates for the lower returns on capital. Lastly, Chatra said domestic companies are averse to dilution, making it difficult for international private equity firms to invest in Indian infrastructure companies since the private equity firms usually want rights and control. According to Chatra, the market is starting to see solutions to this problem with growing use of mezzanine financing and convertible five- to seven-year bonds linked to an IPO, or private equity firms taking an initial passive role but later getting a more active management role.

¶8. (SBU) Despite infrastructure needs in most sectors, foreign investors only find a few sectors attractive. Going through many of the sectors, Chatra discounted water projects as having too much political risk, dismissed telecom as too mature of a market to generate investable returns, and crossed off rail projects due to unclear policies and legislation regarding track usage and rates. Airport and ports were okay to invest in, said Chatra, but road projects have had significant problems in the past and it still remains to be seen if Minister of Roads and Transport Kamal Nath will change this. Even if Nath does make the necessary changes, Chatterjee thought American companies still would not be interested in the road sector since it is not high tech enough and they cannot compete with Indian and Chinese contractors on price. (In general, Chatterjee did not think Americans were really interested in Indian infrastructure as developers or investors. American companies, he felt, were only interested in being equipment sellers.)

¶9. (SBU) Power, however, was the one attractive sector that would be a good story for a long time as the Indian power deficit is expected to last until at least 2015, according to Chatra. Joint Secretary Mohan said India initially planned to increase power generation by 80,000 megawatts by 2012 but now expects to build 50,000 megawatts. The shortfall was due to land acquisition problems and fuel supply issues. Mohan also thought the original target was too ambitious and noted that in the Tenth Five-Year Plan, India was only able to build 20,000 megawatts of new power generation.

¶10. (SBU) Comment: At its current pace, India's infrastructure spending is growing six percent annually and equal to approximately five to six percent of GDP. These numbers are about 1.5 to two times slower than what most analysts believe India needs to spend in order to grow its economy at nine percent over a long period of time. The country is not lacking in opportunities, investor interest, or money but will need significant improvement in GOI performance of creating an enabling environment for infrastructure projects to reach its goals. While several units of the central government (e.g. Finance and Roads) have the will to change their performance, state- and local-level governments have not exhibited uniformly convincing reform efforts. It's unclear in India's federal system how much water the center carries, when so much of the critical project creation and land acquisition occurs below the center. End comment.

¶11. (U) Visit New Delhi's Classified Website: http://www.state.sgov/p/sa/newdelhi.

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